INTERIM REPORT NO. 27
FIDUCIARY LAW AND
THE SAN DIEGO PENSION CRISIS

REPORT OF THE

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I.
INTRODUCTION

City pension and union officials, along with their political allies, have made a series of improper and unlawful pension fiduciary decisions that have done great financial damage to the San Diego City Employees' Retirement System [SDCERS], the pension plan for City employees.[1]

Taxpayers now face pension liabilities of more than $2 billion dollars. This debt burden has condemned us and future San Diegans to years of substandard services, deferred maintenance, and deteriorating infrastructure. Although there are some who are representing the pension crisis, San Diego remains in the grip of its worst financial crisis.

This need not be the case. Although the wrongful conduct extended for more than a decade, and exploited holes in our regulatory and oversight systems that must be closed, the City can repair this damage.

This requires that illegal benefits be rescinded. It requires, moreover, that individuals who knowingly, recklessly or negligently violated the law be held accountable.

Among the abuses contributing to the pension crisis are pension benefits given to union presidents in violation of Internal Revenue Service regulations. These benefits appear to have been exchanged for complicity in allowing the City to inappropriately reduce its payments to the pension plan. This occurred at the same time the parties were agreeing to increase benefits the plan was supposedly obligated to pay.

The pension board, for its part, failed in its duty to keep the plan in conformity with requirements that it be financially sound. In other words, the pension system's designated watchdogs allowed the plan to assume obligations it will be unable to pay without massive infusions of cash from the city, which will cripple essential municipal operations and services.

These decisions were made by pension trustees and other interested parties who had substantial personal financial interests in their outcome.

Other decisions were made to allow the City to decrease its contributions to the pension plan below the level required by actuarial standards. These decisions were made in exchange for increased benefits for those on the pension board.

Much of this has been known for several years - and yet the parties involved have not been brought to justice. State and federal cases are stalled. The County prosecutor has brought only limited claims. The U.S. Attorney has brought claims but has been hampered by limited jurisdictional authority.

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[1] See San Diego City Attorney Interim Reports 1-3, 612, 18, 19, 22, and 26 at www.sandiegocityattorney.org.

Underlying the lack of progress in resolving the crisis are many factors, including the absence of meaningful governmental regulation of municipal pension plans. Unlike private pensions, which are highly regulated under federal pension law by the U.S. Department of Labor, no agency is charged with the duty of regulating San Diego's pension. City officers and pension officials are not required to file the pension related reports with the labor department.[2]

Because of these and other regulatory gaps the San Diego City Attorney urges federal legislators to review the need to extend the protection of Employment Retirement Income Security Act (ERISA) to municipal pension plans, like San Diego. Unlike pension plans for private enterprise, municipal plans escape much of the essential oversight that has prevented the worst abuses of private pension systems.

This 27th Interim Report aims to contribute of that review through a discussion of existing law and the need to extend the ERISA protections.

This report is written to inform City officials, pension officials, and the public of critical facts. It is also written to inform federal legislatures to prompt an investigation by an appropriate Congressional committee to determine if ERISA should be extended to municipalities.

Following a review of the federal ERISA, which regulates private pension plans, is a discussion of applicable California fiduciary law. Much of the protection that ERISA brings to private plans can be accomplished for municipal pensions by adapting California law.

Unfortunately, the report also concludes that no enforcement agency has stepped up to the task of applying state law to the abuses and illegality that has plunged San Diego's municipal plan into crisis.

It is the hope of this office that growing awareness of the facts and circumstances of the San Diego pension debacle will build support for tackling this law enforcement task, one that must be taken on to ensure a stable pension system for loyal city employees and fiscal stability for the City.

II.
U.S. CONGRESS FINDS WIDESPREAD PENSION ABUSE

To understand the system in place to protect and regulate private pension plans, one must look back more than 50 years.

Between 1957 and 1959, a U.S. Senate Committee investigation headed by then-Senator John F. Kennedy and his brother Robert F. Kennedy, uncovered widespread abuse of workers' pensions. The investigation led to the passage of the Welfare and Pension Plan Disclosure Act based upon the following findings:

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2 The Municipal exemption from ERISA is set forth in 29 U.S.C.A. § 1003(b)(1).

Findings And Policy

> Sec. 2. (a) The Congress finds that the growth in size, scope, and numbers of employee welfare and pension benefit plans in recent years has been rapid and substantial; that the continued well-being and security of millions of employees and their dependents are directly affected by these plans; that they are affected with a national public interest; that they have become an important factor affecting the stability of employment and the successful development of industrial relations; that they have become an important factor in commerce because of the interstate character of their activities, and of the activities of their participants, and the employers, employee organizations, and other entities by which they are established or maintained; that owing to the lack of employee information concerning their operation it is desirable in the interests of employees and their beneficiaries, and to provide for the general welfare and the free flow commerce, that disclosure be made with respect to the operation and administration of such plans.
>
> (b) It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee welfare and pension benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto. [3]

The legislative record supporting these findings was built from years of extensive investigation that uncovered widespread abuses of pension plans. The record was memorialized in hearings and reports of the Senate Select Committee on Improper Activities in the Labor or Management Field (Select Committee). A summary of the findings of relevance to this report was contained in the Congressional Record supporting the introduction of the Welfare Pension Plan Disclosure Act in 1958:

> **Senator Paul H. Douglas:**
> Abuses Uncovered by Investigating Committee
> Now let me turn to some of the specific things which we found in our investigations. We found that the characteristics of these plans and their extremely fast rate of growth and development made them susceptible to weaknesses, waste, abuses, and unnecessary losses to the beneficiaries. Their bigness, the grouping together for coverage of large numbers of people, the pooling of vast sums of money, the size of insurance premiums, third party or management control of the plans, accompanied by vagueness about employee rights and an attitude in certain quarters that the employees have no right to know the finances of the plans are

[3] Welfare and Pension Plan Disclosure Act with Findings (with 1962 Amendments) [Exhibit 1].

> managed, have made them vulnerable to a host of infirmities and have thrown temptation in the path of the unscrupulous. [4]

At this point in the Congressional Record, then-Senator John F. Kennedy noted that the rapid growth of private pension plans had brought not only benefits to many, but also abuses that "out-distance existing laws." Now the growth of municipal pensions has revealed another regulatory gap, one that has allowed abuses in these public plans that would not be tolerated in the private sector. [5]

There was broad consensus among labor's strongest supporters that reform legislation was needed to protect workers' pensions and to rid the labor movement of any corrupt element. This point of view was expressed by one of labor's strongest friends, Senator Hubert H. Humphrey, during the Senate floor debate on pension reform legislation in August 1958:

> There is no question that legislation in this field is needed, and there is no question in my mind but what S. 2888 is a constructive and effective proposal… As a friend of organized labor I wish to see the American labor movement clean, strong, and responsible. The few who abuse their power or are guilty of corruption, misuse of funds, or any other form of unethical conduct serve only to bring discredit upon the good name and reputation of organized labor. Unions are part of the American political, social and economic structure. It has taken courage, steadfastness of purpose, sacrifice, and great leadership to build the American labor movement. There is no room within its organization for those who would violate their trust.

Sen. Hubert Humphrey Congressional Debate Welfare Pension Plan Disclosure Act.[6]

III.
HISTORY OF FEDERAL PENSION REFORM LAW

The Welfare and Pension Plan Disclosure Act [WPPDA]-the first major attempt at regulation - was followed by ERISA.[7] The WPPDA, as reinforced by ERISA, extended Congressional oversight to a broader range of retirement programs, as lawmakers came to appreciate the importance of these plans to the well-being and security of millions of employees and their dependents.[8]

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4 This is contained in the Department of Labor, Legislative History of the Welfare and Pension Plans Disclosure Act of 1958, as amended by Public Law 87-420 of the 1962 Washing D.C. p. 13.

5 U.S. Department of Labor, Legislative History of the Welfare and Pension Plans Disclosure Act of 1958, as amended by Public Law 87-420 of 1962 Washington D.C., p. 74. [Exhibit 2].

6 Legislative History of the Welfare and Pension Plans Disclosure Act of 1958 as amended by Public Law 87-420 of 1962 pp13, 119. [Exhibit 3].

7 ERISA Practice and Procedure § 1:1. [Exhibit 4].

8 ERISA § 2, 29 U.S.C.A. § 1001. [Exhibit 5].

The foundation of ERISA was built on the philosophy that disclosure and other safeguards are needed to protect employees with long years of employment from losing anticipated retirement benefits.[9] The House Education and Labor Committee Report defined ERISA's purposes as follows:

> (1) to establish minimum standards of fiduciary conduct for Trustees, Administrators and others dealing with retirement plans, to provide for their enforcement through civil and criminal sanctions, to require adequate public disclosure of the plans' administrative and financial affairs, and (2) to improve the equitable character and soundness of private pension plans by requiring them to: (a) vest the accrued benefits of employees with significant periods of service with an employer, (b) meet minimum standards of funding and (c) guarantee the adequacy of the plan's assets against the risk of plan termination prior to the completion of the normal funding cycle by insuring the unfunded portion of the benefits promised.[10]

Congress sought to guarantee that vested benefits would be received as long as the conditions of eligibility were met, that sufficient funds were accumulated to pay those pension benefits, and that workers were guaranteed honest administration of their plans.[11]

Criminal provisions were added to pension law enforcement by the addition of 18 U.S.C.A.§1954, which was adopted with the amendments to the WPPDA in 1962. Under 18 U.S.C.A. § 1954, it was unlawful for plan, employer, or union officers or employees to take, solicit or offer, or pay things of value to, because of or with the intent to be influenced with respect to any pension plan actions, decisions, or other duties.

ERISA applies to "employee pension benefit plans" established by an employer for the purpose of providing retirement income.[12] This law requires that participants be provided with full disclosure through regular plan summaries, which must be drafted in language understandable by the average plan participant. The plan summary must include a statement of the participant's rights based on current information and a copy of the plan's annual financial report. The information furnished to participants also must be filed with the Secretary of Labor.[13]

In addition, all employee benefit plan administrators are required to publish an annual report, including financial statements, actuarial statements, and other statistical information relative to the plan.[14] A plan administrator is also required to furnish, upon written request by plan participants or beneficiaries, information showing accrued

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9 ERISA § 2, 29 U.S.C.A. § 1001. [Exhibit 5].

10 ERISA Practice and Procedure § 1:1. [Exhibit 4].

11 *Amato v. Bernard*, 618 F. 2d 559 (9th Cir. 1980). [Exhibit 6]; *Pompano v. Michael Schiavone & Sons*, 680 F. 2d 911 (2d Cir.1982). [Exhibit 7].

12 ERISA§ 3(2)(A), 29 U.S.C.A. § 1002(2)(A)). [Exhibit 8].

13 ERISA §§ 102, 104, 29 U.S.C.A. §§ 1022, 1024. [Exhibits 9 and 10].

14 ERISA § 103, 29 U.S.C.A. § 1023. [Exhibit 11].

benefits, percentage vested, and, if not fully vested, the time at which vesting will occur.[15]

ERISA specifies minimum standards for funding employee pension benefit plans[16] and allows for certain variances from those minimum funding standards. Unfortunately City pension plans have been exempted from these and other ERISA requirements. Moreover, there is no agency specifically charged with enforcing the fiduciary duties in ERISA against municipal unions. There are also no filing requirements for municipal unions for reports to the U.S. Labor Department unlike private pension plans. However, California Court can consider ERISA when they interpret state fiduciary law.

IV.
WHO IS A FIDUCIARY TRUSTEE?

ERISA sets out strict standards of behavior for those who administer or manage pension plans. A fiduciary is one who exercises any discretionary authority or discretionary control over the management of the plan. In simpler terms, a fiduciary is one who has the power to spend pension money or set pension board policy.

Fiduciaries also include those who exercise any authority or control respecting disposition of plan assets.[17]

In general, a fiduciary is:

> a person … to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.[18]

A party becomes a fiduciary by holding a fiduciary position or by performing a fiduciary function.[19] Those who perform basic functions relating to asset management, plan administration, and provision of investment advice for a fee are routinely held to be fiduciaries. The appointment of fiduciaries is itself a fiduciary function.[20]

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15 ERISA §§ 105, 209, 29 U.S.C.A. §§ 1025, 1059. [Exhibits 12 and 13].

16 ERISA § 301, 29 U.S.C.A. §1081; ERISA § 302, 29 U.S.C.A. §1082. [Exhibits 14 and 15].

17 Fiduciary Litigation Under ERISA, Practicing Law Institute (PLI) p. 2. [Exhibit 16].

18 ERISA §3(21)(A), 29 U.S.C.A. § 1002(21)(A). [Exhibit 8].

19 Fiduciary Litigation Under ERISA, Exhibit 8; 29 C.F.R. § 2509.75-8 at D-3. [Exhibit 17].

20 29 C.F.R. § 2509.75-8 at D-4 [Exhibit 17]; *Hickman v. Tosco Corp.*, 840 F. 2d 564, 566 (8th Cir. 1988) [Exhibit 18]; *Ed Miniat, Inc. v. Globe Life Ins. Group, Inc.*, 805 F. 2d 732, 735-736 (7th Cir. 1986) [Exhibit 19]; *Gelardi v. Pertec Computer Corp.*, 761 F. 2d 1323, 1325 (9th Cir. 1985) [Exhibit 20].

Courts have established a widely encompassing definition to determine whether one is a fiduciary.[21] One can become a fiduciary, for example, if he or she exercises *de facto* control over a fiduciary function.[22] A union official becomes a plan fiduciary by exercising control over plan administration.[23]

Following the functional and *de facto* approaches to determining fiduciary status, a few cases have imposed fiduciary status and liability on individuals within a corporation or other entity who actually perform the functions which make the entity a plan fiduciary. [24] If a plan instrument confers upon a fiduciary the right to select and remove other fiduciaries, this authority carries with it an ongoing "duty to monitor" those persons whom the fiduciary may remove. [25]

Fiduciary duties generally begin immediately upon assumption of fiduciary status.[26] However, a fiduciary can be liable for transactions that begin before the fiduciary service started. For example, a transaction may involve a ongoing breach of fiduciary duty, *e.g.* an ongoing prohibited extension of credit, and may thus create a present duty to remedy the transaction. [27]

V.
FIDUCIARY DUTY

ERISA establishes fiduciary management standards. In essence, the basic fiduciary requirements of ERISA are: (1) a duty of loyalty by the fiduciary to the plan and its participants; (2) a duty of care, skill, prudence and diligence; (3) a duty of diversification;

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21 *Beddall v. State Street Bank & Trust Co*., 137 F. 3d 12 (1st Cir. 1998) (statute also extends fiduciary liability to functional fiduciaries) [Exhibit 21]; *Olson v. E.F. Hutton & Co*., 957 F. 2d 622, 625 (8th Cir. 1992) [Exhibit 22]; *Acosta v. Pacific Enter.*, 950 F. 2d 611, 618 (9th Cir. 1991) (a person's actions not the official designation of his role determine whether he enjoys a fiduciary status) [Exhibit 23]; *Brock v. Hendershott,* 840 F.2d 339, 342 (6th Cir. 1988) (union official becomes plan fiduciary by exercising control over plan administration) [Exhibit 24].

22 *Concha v. London,* 62 F. 3d 1493 (9th Cir. 1995) (there need not be an express delegation of fiduciary authority for persons performing duties of a fiduciary nature to be considered fiduciaries) [Exhibit 25].

23 *Brock v. Hendershoff,* 840 F. 2d 339, 342 (6th Cir. 1988) [Exhibit 24].

24 *Kayes v. Pacific Lumber Co*., 51 F. 3d 1449 (9th Cir.1995) (corporate officers are liable as fiduciaries on the basis of their conduct and authority with respect to ERISA plans whether or not they are acting on behalf of the corporation or outside their authority) [Exhibit 26]; *Kay v. Thrift & Profit Sharing Plan for Employees of Boyertown Casket Co.*, 780 F. Supp. 1447, 1461. (E.D. Pa. 1991) (holding that company and employees who were instrumental in plan decision found to be a breach of duty were all personally liable for breach) [Exhibit 27].

25 See 29 C.F.R. § 2509.75-8 at FR-17 [Exhibit 17]; *Leigh v. Engle*, 727 F. 2d 113, 135 (7th Cir. 1984) [Exhibit 28]; *Newton v. Van Otterloo*, 756 F. Supp. 1121, 1132 (N.D. Ind. 1991) (directors have duties to monitor plan fiduciaries whom they appoint but do not breach duties in the absence of "notice of possible misadventure by their appointees") [Exhibit 29]; See, ERISA Practice and Procedure p. 5 [Exhibit 30].

26 *Free v. Briody,* 732 F. 2d 1331, 1334-1335 (7th Cir. 1984) [Exhibit 31].

27 See *Freund V. Marshall & Ilsley Bank*, 485 F. Supp. 629, 635 (W.D. Wis. 1979) [Exhibit 32].

(4) a duty to follow the governing documents if consistent with law, and (5) a duty not to engage in prohibited transactions.[28]

Specifically, ERISA's fiduciary standard provides:

> (1)[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and
>
> (A) for the exclusive purpose of:
>
> (i) providing benefits to participants and their beneficiaries; and
>
> (ii) defraying reasonable expenses of administering the plan;
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
>
> (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
>
> (D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter III of this Chapter.[29]

The fiduciary must act "solely in the interest" of the plan and plan participants and for "the exclusive purpose" of providing plan benefits and defraying reasonable expenses of plan administration. The most clear-cut application of these requirements has come in cases where a fiduciary has acted in his or her own personal interest.[30]

Courts frequently rely on evidence of imprudence to establish a breach of the duty of loyalty. In *Davidson v. Cook,* the court found a breach of the prudence fiduciary standard when they were "attempting to also satisfy the desires and needs" of a union and not acting for the exclusive purpose of providing plan benefits. The court noted that it "is always difficult" to determine "purpose and intent" and relied on "circumstantial evidence and reasonable inferences" to determine that the fiduciaries had not dealt with the union at arm's length and thus had violated their duty of loyalty.[31]

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28 ERISA , 29 U.S.C.A. § 1104(a)(1)(A)-(D) [Exhibit 33].

29 ERISA , 29 U.S.C.A. § 1104(a)(1)(A)-(D) [Exhibit 33].

30 *Teamsters Local No. 145 v. Kuba,* 631 F. Supp. 1063, 1072 (trustees who supported plan amendment which would have permitted them to retain trustee positions even if they lost their union offices violated section 404(a)(1)(A)) [Exhibit 34]; *Donovan v. Daugherty*, 550 F. Supp. 390, 409-410 (S.D. Ala 1982) (trustees who unlawfully made themselves and plan attorney eligible for plan benefits violated section 404(a)(1)(A)) [Exhibit 35].

31 *Davidson v. Cook*, 567 F. Supp. 225, 236 (E.D. Va. 1983) [Exhibit 36].

In another case, the court determined the fiduciaries had not dealt with a union at arm's length and thus had violated their duty of loyalty.[32] A fiduciary violates the prudence standard when a fiduciary favors the interests of a third party.[33]

Plan fiduciaries can also breach their duty of loyalty by misrepresenting important facts about the plan.[34] A fiduciary who failed to explain the negative tax consequences participants might face from benefit distributions violated the accurate disclosure requirements.[35]

San Diego pension fiduciaries have carried out a misleading campaign to convince plan participants, taxpayers, and the public that the pension plan is in sound financial condition. This has been accomplished by short-term transfer of funds from the City, changes in actuarial funding methods, and the manipulation of actuarial assumptions to make the plan appear less at risk.

Plan fiduciaries who participate a campaign to mislead, violate their fiduciary duty of honesty. Those who disseminate misinformation and do not question it violate their fiduciary duty of due care and prudence.

The ERISA duty requires the fiduciary to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise.

Courts have characterized prudence as "an objective standard which can be consistently applied in all cases.[36] Subjective good faith is not a defense to a charge of imprudence.[37] In *Donovan v. Bierwirth,* the court stated that fiduciary duties under ERISA "the highest known to the law." [38]

By objective standard, it is meant what a reasonable person would consider appropriate action under the circumstances. [39] It is difficult to have sincere ignorance (subjective

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32 *Davidson v. Cook,* 567 F. Supp. 225 (E.D. Va. 1983) [Exhibit 36].

33 *Pension Benefit Guar. Corp. v. Solmsen,* 671 F. Supp. 938, 945-946 (E.D.N.Y. 1987) (fiduciary violates duty by using employee contributions for corporate purposes) [Exhibit 37].

34 *Taylor v. Peoples Natural Gas Co*., 49 F. 3d 982 (3d Cir. 1995) (plan administrator can be held liable for breach of fiduciary duty for misrepresentations by company employee responsible for benefits matters) [Exhibit 38].

35 *Farr v. US West Comm*., 151 F. 3d 908 (9th Cir. 1998) [Exhibit 39].

36 *Katsaros v. Cody,* 744 F. 2d 270, 279 (2d Cir. 1984) [Exhibit 40].

37 *Donovan v. Cunningham*, 716 F. 2d 1455, 1467 (5th Cir. 1983) ("a pure heart and an empty head are not enough") [Exhibit 41].

38 *Donovan v. Bierwirth*, 680 F. 2d 263, 272 n. 8 (2d Cir. 1982). [Exhibit 42].

39 *Katsaros v. Cody,* 744 F. 2d 270, 279 (2d Cir. 1984) [Exhibit 40]; *Donovan v. Mazzola*, 2 EBC 2115, 2133 (N.D. Cal. 1981) [Exhibit 43].

good faith) and be prudent. The whole idea of prudence is to take the steps needed to make an informed decision.[40]

In *Donovan v. Mazzola*,[41] the court described this standard as derived from "the prudent person test as developed in the common law of trusts;" the court noted that the standard was to be applied in light of "the special nature and purpose of employee benefit plans" and that the common law of trusts has been made "more exacting" in ERISA.

Although, a fiduciary acts prudently when he or she consults with an expert, the fiduciary bears the ultimate responsibility to make a prudent decision.[42]

The remedy for a breach of fiduciary obligations is personal liability to make good any losses resulting to the plan from the breach.[43] ERISA also prohibits fiduciaries from attempting to absolve themselves of liability under this section.[44] The statute of limitations for breach of fiduciary obligation is the earlier of: (1) six years from the date of the last breach or the last date on which the violation could be cured, or (2) three years from the earliest date on which the plaintiff had knowledge.[45]

VI.
PROHIBITED TRANSACTIONS

ERISA § 406(a) 29 U.S.C.A 1106 prohibits a fiduciary from entering into a transaction that he "knows or should know" is a transaction with a party in interest. Congress adopted section 406(a) to prevent plans from engaging in certain types of transactions that had been used in the past to benefit other parties at the expense of the plans' participants and beneficiaries.

Specifically, ERISA § 406(a), 29 U.S.C.A. § 1106 provides:

> (a)
>
> (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect—
>
> (A) sale or exchange, or leasing, of any property between the plan and a party in interest;

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40 *Donovan v. Cunningham*, 716 F. 2d 1445, 1467 (5th Cir. 1983) ("a pure heart and an empty head are not enough") [Exhibit 41].

41 *Donovan v. Mazzola,* 716 F. 2d 1226, 1231 (9th Cir. 1983).

42 See *Howard v. Shay,* 100 F. 3d 1484 (9th Cir. 1996) (a fiduciary "is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense") [Exhibit 44]; *Donovan v. Mazzola,* 716 F. 2d 1226, 1234 (9th Cir. 1983) [Exhibit 43].

43 ERISA § 409, 29 U.S.C.A. § 1109. [Exhibit 45].

44 ERISA § 410, 29 U.S.C.A. § 1110. [Exhibit 46].

45 ERISA § 413, 29 U.S.C.A. § 1113. [Exhibit 47].

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107(a) of this title.

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property, if he knows or should know that holding such security or real property violates section 1107(a) of this title.

(b) A fiduciary with respect to a plan shall not—

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

(c) Transfer of real or personal property to the plan by party in interest. A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer. [46]

A "party in interest" is defined in ERISA § 1002 (14).

(14) The term "party in interest" means, as to an employee benefit plan—

(A) any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan;

(C) an employer any of whose employees are covered by such plan;

(D) an employee organization any of whose members are covered by such plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.

(ii) The capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a relative (as defined in paragraph (15)) of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of—

[46] ERISA § 406, 29 U.S.C.A. 1106 [Exhibit 48].

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or

(I) a 10 percent or more (directly or indirectly in capital or profits) partner or joint venturer of a person described in subparagraph (B), (C), (D), (E), or (G).

A fiduciary must act prudently to determine whether a party-in-interest relationship exists prior to entering a transaction.[47] Among the types of transactions that have been found to be prohibited transactions are loans,[48] payment or transfers of assets,[49] and transfer of plan assets for the benefit of parties in interest.[50]

One court has held that Section 406(a)(1)(D) involves "two distinct prohibited transactions:" (1) a transfer to a party in interest of any assets of a plan; and (2) a use of plan assets by or for the benefit of a party in interest.[51]

Self-dealing by fiduciaries is also considered a prohibited transaction.[52] Section 406(b)(2) also prohibits a fiduciary from acting in a transaction involving a plan on behalf of a party with interests adverse to the plan.[53]

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47 *Marshall v. Kelly*, 465 F. Supp. 341, 351 (W.D. Okla. 1978) [Exhibit 49]. The court, quoting from the ERISA Conference Report, held that a fiduciary must act prudently in determining whether a party-in-interest relationship exists prior to entering a transaction and that actual knowledge of illegality is not required.

48 *M & R Inv. Co. v. Fitzsimmons*, 685 F.2d 283 (9th Cir. 1982) [Exhibit 50].

49 *Pension Benefit Guar. Corp. v. Fletcher,* 750 F. Supp. 233 (W.D. Tex. 1990) [Exhibit 51].

50 *Leigh v. Engle*, 727 F.2d 113, 126-27 (7th Cir. 1984) [Exhibit 28].

51 *Voluntary Employees Beneficiary Ass'n v. Ross,* 191 F.3d 462 (9th Cir. 1999) (Not Published)

52 *Patelco Credit Union v. Sahni*, 262 F.3d 897 (9th Cir. 2001) (fiduciary, who sets his own compensation and collects the amount from plan assets, violates ERISA § 406(b)(1)) [Exhibit 52]; *Weisler v. Metal Polishers Union*, 533 F.Supp. 209 (S.D.N.Y. 1982) (fiduciary participates in decision to pay himself an excessive salary from plan) [Exhibit 53].

53 *Cutaiar v. Marshall,* 590 F.2d 523 (3d Cir. 1979) in which the court held that, because the interests of a borrower and lender "are, by definition" adverse, trustees violated section 406(b)(2) when

A fiduciary who sits in on a decision to bring suit against himself or herself also commits a prohibited transaction. [54]

ERISA includes a provision highly relevant to San Diego's pension crisis, the "anti-kickback" law. It prohibits a fiduciary from receiving "any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan." [55]

In *Lowen v. Tower Asset Mgmt,*[56] the court found Section 406(b)(3) violations when fiduciaries received various consideration, including finders' fees and equity interests from certain enterprises in which they invested plan assets. The court laid down a two-part alternative test that fiduciaries must pass when they are "charged with a violation of [Section 406(b)(3)]" (presumably meaning when a prima facie violation of Section 406(b)(3) has been shown).

The fiduciary must either: 1) prove by a preponderance of evidence that an exemption applies, or 2) prove by clear and convincing evidence that the consideration received is not "in connection with a transaction involving the assets of the plan."

VII.
ERISA ENFORCEMENT

The Department of Labor, through its Employee Benefit Security Administration [EBSA], will take legal action under ERISA against pension plan officials who fail to operate a plan prudently and for the exclusive benefit of participants. The Labor Department will also take action against those who use plan assets to benefit certain parties related to the plan, including the plan administrator, the plan sponsor, and parties related to these individuals.

The Department of Labor, through the EBSA, also enforces applicable ERISA provisions against plan officials who take adverse action against an individual for exercising his or her rights under the plan (*e.g.*, being fired, fined, or otherwise being discriminated against).

ERISA also contains administrative and enforcement procedures, calling for criminal penalties[57]and also for civil enforcement [58] by participants, beneficiaries, fiduciaries, or

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they negotiated a loan between two plans which they both served as trustees. [Exhibit 54]. Cases following *Cutaiar* as to loans include: *Donovan v. Mazzola,* 716 F.2d 1226, 1236-8 (9th Cir. 1983) [Exhibit 43].

54 *Iron Workers Local No. 272 v. Bowen,* 624 F.2d 1255, 1261 (5th Cir. 1980) (trustee would violate section by participating in decision whether plan should sue him) [Exhibit 55].

55 Section 406(b)(3).

56 *Lowen v. Tower Asset Mgmt.*, 829 F.2d 1209, 1214-16 (2d Cir. 1987). [Exhibit 56].

57 ERISA § 501, 29 U.S.C.A. § 1131 [Exhibit 57].

58 ERISA § 502, 29 U.S.C.A. § 1132 [Exhibit 58].

the Secretary of Labor. The law gives authority for investigations to the Department of Labor.[59]

The U.S. Department of Justice works with the EBSA in conducting investigations within employee benefit plans of criminal violations such as embezzlement, kickbacks, and false statements under Title 18 of the U.S. Criminal Code. Prosecutions of these criminal violations are handled by U.S. Department of Justice.

VIII.
CALIFORNIA FIDUCIARY LAW

California regulation of municipal pension plans is as a practical matter non-existent. However, California law establishes basic fiduciary duties for the administration of public trusts similar to the general duties delineated in ERISA. But there is virtually no enforcement of those provisions by any government body.

Specifically, Article 16 § 17 of the California State Constitution provides part of the basic fiduciary law governing California public pensions. But in California there is no enforcement authority equivalent to the role played by the US Department of Labor. The California law provides:

> (a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.
>
> (b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.
>
> (c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then

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[59] ERISA § 504, 29 U.S.C.A. § 1134 [Exhibit 59].

> prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.
>
> (d) The members of the retirement board of a public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.
>
> (e) The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system. [60]

IX.
APPLICATION TO SDCERS

The San Diego City Attorney, outside attorneys hired by the City Council, SDCERS outside counsel, the Securities and Exchange Commission, and the Internal Revenue Service have all found evidence of violations of numerous laws related to the pension debacle.

Exchanging increased pension benefits for decreased contributions, as occurred in 1996 and 2002 by those who would personally profit, constitute prohibited transactions. [61]

Two mayors and several council members participated in offering to the pension board and union leaders enhanced pension benefits in exchange for decreased contributions in 1996 and 2002. The Council members reviewed and approved the benefit for contributions proposals. They submitted those proposals to the pension board they helped to appoint. The Council provided indemnity to City staff to induce their involvement in the 2002 transaction. Council members met with City staff on several occasions to consummate the transaction. These contacts were so extensive and certain Council members were so deeply involved that an argument could be made that some of the Council members became plan fiduciaries.

This conclusion is further supported by the fact that several council members stood to benefit personally from the arrangements.

The fact that the plan administrator and fiduciaries have gone to such lengths as to misrepresent the financial condition of the plan in order to hide the unsustainable costs caused by the mismanagement of the plan also could constitute a breach of fiduciary

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[60] California Constitution Article 16 § 17 [Exhibit 60].

[61] See 29 U.S.C.A § 1106.

duties. The SEC has documented these misrepresentations in the cease and desist order brought against the City.

Other breaches of fiduciary duty are implicated by the following:

(1) failing to operate DROP[62] on a cost neutral basis;

(2) failure to collect full price for purchased pension service credits sold;

(3) allowing purchased service credits to be used to meet the five-year vesting and 20-year early retirement requirement;

(4) not amortizing the pension debt on a 15-year basis;

(5) allowing elected officials to buy service credits for years beyond the period permitted by term limits;

(6) allowing SDCERS trustees and staff to participate in decisions in which they have a personal stake in keeping the unlawful pension benefits;

(7) allowing the union presidents who are not plan participants to be in the City pension plan;

(8) waiving interest on service credits bought by one union president;

(9) allowing a union president on the pension board to get a personal benefit in connection with his effort to persuade the board to approve the increased benefits/ decrease contribution deal, which plays a large role in the pension shortfall;

(10) allowing union members to vote on matters urged upon them by their union attorney and union president in which the union president has a personal financial interest.

Attached to this report are relevant reports from this office and those of outside counsel, as well as applicable criminal charging documents. Also included is the City Attorney's Interim Report No. 24, which details the financial condition of the pension plan.

Applying the responsibility for prudence and other provisions of ERISA to the fiduciaries at SDCERS, raises a number of probable violations. The questionable transactions include:

(1) Managers Proposal 1: In 1996, during the term of Mayor Susan Golding, the City Council gave increased pension benefits to pension board members and staff

[62] DROP refers to the Deferred Retirement Option Program which allows those who qualify for retirement to extend their employment for five years and accumulate a lump sum in a DROP account.

participating in the transaction in exchange for agreeing to allow the City to make pension payments below the level required to meet the plan's supposed obligations. The City Council amended the Municipal Code to allow union presidents employed by their unions to participate in the City's pension plan in violation of the Internal Revenue Code [IRC].

(2) Union Presidents Allowed Into City Pension: In 1997, City and Pension officials agreed to permit the Municipal Employees Association's president to participate in the City pension based upon her union salary in violation of the IRC. These officials in October 1997 acknowledged that the Police Officer's Association presidents were allowed to join the City pension based upon their union salary.

(3) Managers Proposal 2: In 2002, under Mayor Dick Murphy, the City Council gave increased pension benefits to the pension board in exchange for decreasing the City's contribution to the pension below the level required. The City Council also amended the Municipal Code to allow union presidents employed by their unions to participate in the City's pension plan in violation of the IRC.

(4) Purchase Service Credits Sold Below Actual Cost: Between 1997 and 2003, more than 20,000 service years were sold to City employees below the actual cost, in violation of the San Diego Municipal Code, which required actual cost pricing.

(5) Operating DROP Above Actual Cost: Beginning in 1997, the City began a Deferred Retired Option Plan [DROP] on an above-cost basis, an action that also contributes to the pension system's asset shortfall.

(6) Use of Purchased Service Credits for Early Vesting: SDCERS is allowing participants in the pension plan to count five years of purchased service years toward the 10-year vesting requirement.

(7) Use of Purchased Service Credits for Early Retirement: SDCERS is allowing participants in the pension plan to count five years of purchased service years toward the 20 years early retirement at age 55 provision.

(8) Use of 20-Year Amortization Rather Than 15: SDCERS is using an amortization period longer than the 15-year period voters adopted in the 2004 election.

(9) Allowing Elected Officials to Purchase Service Years: SDCERS is allowing elected officials to buy up to five years of service credits beyond their terms of office.

WHO APPOINTED BOARD MEMBERS?

Mayor Murphy	**Acting Mayor Toni**	**Mayor Jerry Sanders**	**Unions/Retiree**

	Atkins		
William Sheffler	George Murray	Susan Gonick	John Thomson (Fire Fighter)
Peter Preovolous	Thomas Herbank	Wayne Kennedy	Franklin Lamberth (Local 127)
		JoAnne SawyerKnoll	Mark Sullivan (POA)
			Steve Meyer
			Carmen Lutes (Retiree)

ACTIONS BY PENSION BOARD RAISING FIDUCIARY ISSUES

Name	Appointed/ Elected	Benefits	Compliance Issues Raised
William Sheffler	Murphy	Voted to allow parties in interests to keep under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Peter Preovolous	Murphy	Voted to allow parties in interests to keep under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
George Murray	Atkins	Voted to allow parties in interests to keep under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Thomas Herbank	Atkins	Voted to allow parties in interests to keep under priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Susan Gonick	Sanders	Voted to allow parties in interests	Prudence, Prohibited Transactions

		to keep under-priced service credits; failed to take remedial action ongoing violations	
Name	**Appointed/ Elected**	**Benefits**	**Compliance Issues Raised**
Wayne Kennedy	Sanders	Voted to allow parties in interests to keep under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
JoAnne SawyerKnoll	Sanders	Voted to allow parties in interests to keep under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Mark Sullivan	POA	Retroactive benefits;	Prudence, Prohibited Transactions, Adverse Interests
Franklin Lamberth	Local 127	Retroactive benefits; Union supported MP-1 and MP-2; underpaid for 5 years of service credits on 22 April 03	Prudence, Prohibited Transactions, Adverse Interests
John Thomson	Fire Fighter 145	Retroactive benefits; underpaid for 2.13 years of service credits on 6 Oct 2003; increased salary by limited time as Assistant Fire Chief	Prudence, Prohibited Transactions, Adverse Interests
Steve Meyer		Retroactive benefits; underpaid for 5 years of service credits on 20 Sept 2003	Prudence, Prohibited Transactions, Adverse Interests
Carmen Lutes	Retiree (Union)	Retroactive benefits	Prudence, Prohibited Transactions

ACTIONS BY PENSION BOARD STAFF RAISING FIDUCIAY ISSUES

Name	Staff Position	Benefits	Compliance Issues Raised
David Westcoe	Administrator	Supported parties in interests to keeping under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions,
Roxanne Story-Parks	Chief Compliance Officer	Retroactive benefits; under-paid for 5 service credit years on 5 June 2000	Prudence, Prohibited Transactions, Adverse Interests
Bob Wilson	Internal Auditor	Retroactive benefits; under-paid for 5 service credit years on 3 Aug 2001	Prudence, Prohibited Transactions, Adverse Interests
David Arce	Director Benefits Administration	Retroactive benefits; under-paid for 5 service credit years on 6 December 2004	Prudence, Prohibited Transactions, Adverse Interests
Mark Hovey	Chief Financial Officer	Supported parties in interests to keeping under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Doug McCalla	Chief Investment Officer	Retroactive benefits; under-paid for 4.4 service credit years on 12 Jan 2001	Prudence, Prohibited Transactions, Adverse Interests

Name	Staff Position	Benefits	Compliance Issues Raised
Chris Waddel	General Counsel	Supported parties in interests keeping under-priced service credits; failed to take remedial action ongoing violations	Prudence, Prohibited Transactions
Rebecca Wilson	Director Member Services	Under-paid for 5 service credit years on 9 Nov 2004	Prudence, Prohibited Transactions, Adverse Interests

<u>ACTIONS BY UNION OFFICIALS RAISING FIDUCIAY ISSUES</u>

Union	Person	Benefits	Compliance Issues Raised
Fire Fighters	Ron Saathoff	Presidential benefits IRS revoked; retroactive benefits; bought service credit years; DROP	Prudence, Prohibited Transactions, Adverse Interests
POA	Bill Nemec	Presidential Benefit; City pays his salary; employment taxes not withheld; bought .8 years 7 Jul 2002; bought .15 service credits 7 Jul 2002; active DROP	Union employee failure to have employment taxes withheld on presidential salary paid by City
MEA	Howard Guess Jr.	Retroactive benefits; underpaid for 5 service years on 9 Jul 2004	Union employee failure to have employment taxes withheld

KEY PLAYERS WHO STAND TO GAIN FROM UNLAWFUL BENEFITS

Name	Position	Benefits	Compliance Issues Raised
Susan Golding	Mayor	Voted for MP-1; voted herself retroactive benefits; underpaid for 5 service years on 17 Nov 2000	Prudence, Prohibited Transactions, Adverse Interests
Dick Murphy	Mayor	Voted for MP-2; underpaid for 5 service years on 12 June 2002	Prudence, Prohibited Transactions, Adverse Interests
Casey Gwinn	City Attorney	City Attorney when MP-2 approved; received retroactive benefits approved when he was City Attorney; under-paid for 5 years of service credits on 15 March 2000	Prudence, Prohibited Transactions, Adverse Interests
Christine Kehoe	City Council	Voted for MP-1; voted herself retroactive benefits; underpaid for 5 service years 29 Nov 2000	Prudence, Prohibited Transactions, Adverse Interests
Judy McCarty	City Council	Voted for MP-1; voted herself retroactive benefits; underpaid for 5 service years on 16 Feb 2000	Prudence, Prohibited Transactions, Adverse Interests
Juan Vargas	City Council	Voted for MP-1; voted himself retroactive benefits; underpaid for 5 years on 28 Nov 2000	Prudence, Prohibited Transactions, Adverse Interests

Name	Position	Benefits	Compliance Issues Raised
John Kern	Mayor Staff	Mayor staff when Mayor voted for MP-1; received retroactive benefits; underpaid for service credits May-June 2002; entered DROP	Prudence, Prohibited Transactions, Adverse Interests
Ed Ryan	City Auditor	Auditor when MP-1 and MP-2 approved; received retroactive benefits; underpaid for 5 years 27 Dec 1997	Prudence, Prohibited Transactions, Adverse Interests
Lawrence Grissom	Pension Administrator	Administrator when MP-1 and MP-2 approved	Prudence, Prohibited Transactions, Adverse Interests

ACTIONS BY CITY COUNCIL RAISING FIDUCIAY ISSUES

Name	Position	Benefits	Compliance Issues Raised
Jim Madaffer	City Council	Voted to increase his general member pension credits retroactively July 2002 while on City Council; underpaid for 5 service credit years on 6 Dec 2001; voted in favor of MP-2	Prudence, Prohibited Transactions, Adverse Interests
Toni Atkins	City Council	Voted to increase her general member pension credits retroactively while on the City Council; underpaid for 5 service credit years on 23 Sept 2003; voted in favor of MP-2	Prudence, Prohibited Transactions, Adverse Interests
Brian Maienschein	City Council	Underpaid for 5 service credit years on 20 June 2002; voted in favor of MP-2	Prudence, Prohibited Transactions, Adverse Interests
Scott Peters	City	Voted in favor of MP-2;	Prudence, Prohibited

	Council		Transactions

X.
CONCLUSION

Unlike private pension plans that operate under the structures of ERISA, SDCERS is largely unregulated. No enforcement agency is charged with the duty of protecting municipal pensions. Although basic fiduciary law is included in the California Constitution, the law is not actively enforced. No governmental agency is charged with enforcement of municipal pension law.

The crisis in San Diego has revealed that oversight of public pension systems is where regulation of private pensions was before 1962. This leaves municipal pension plan participants subject to serious abuse without clear immediate remedy. The lack of oversight of these public pension systems must be a paramount concern to plan participants and public officials.

Just as federal pension law reform helped ensure prudent operation of private pensions, the pension debacle in San Diego raises the need for comparable reform of municipal plan oversight. Fortunately, there is a marked path forward.

A significant and obvious step would be to amend ERISA to allow for federal supervision of municipal pensions. In the meantime, local, state, and federal law enforcement agencies must coordinate their response to the current crisis to guarantee that parties who violated their duty to the plan and helped create the San Diego pension crisis are held accountable.

To do less would be to abrogate our responsibility to those who depend on this plan for secure retirement income, as well as to the generation of future San Diegans who could be forced to pay the burden of the system's massive and illegal costs.